Retirement Policy and Research Centre

Submission on the Taxation (Annual Rates, Business Taxation, KiwiSaver, and Remedial Matters) Bill

We request the opportunity to present at the Finance & Expenditure Committee hearing and request that this is held in Auckland.

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1. Introduction

This submission on the Taxation (Annual Rates, Business Taxation, KiwiSaver, and Remedial Matters) Bill (the "Bill") is from the Retirement Policy & Research Centre (RPRC), at the University of Auckland's Business School. [1]

We have major concerns of principle with KiwiSaver as it has now evolved. What started as a relatively simple, universal, workplace-based retirement savings scheme ("KiwiSaver I") has now emerged as "KiwiSaver II", a complex, distortionary, expensive instrument that will add significantly to the cost to New Zealand of our ageing population.

The cost is the extra consumption facilitated through KiwiSaver II by retirees at the expense of tomorrow's working age population. The reforms in almost all other OECD countries have been to reduce their pension promises, not augment them. (OECD *Pensions at a Glance*, 2007).

We also have concerns about:

- the way KiwiSaver I was transformed, virtually overnight and without debate;
- the potential threat that KiwiSaver II now poses to the long-term future of New Zealand Superannuation;
- the absence of a rigorous justification for the changes to KiwiSaver I in the Bill;
- the process of change;
- the absence of local evidence to support the rewrite of the KiwiSaver I framework, even before it began;
- the failure to acknowledge international evidence that indicates KiwiSaver II probably will not "work" (increase national saving to the extent justified by the costs);
- the failure of KiwiSaver II to meet the standards suggested by the OECD for the measurement of good regulatory changes;
- the way in which the government seems now to have re-politicised superannuation as an issue.

It seems that we have not taken seriously the lessons that we learned during the 1974-1993 period and that we are embarking on another period of political instability that will end with a re-learning of those lessons.

We make this submission in recognition that it will probably make no difference to the progress of the Bill. In fact, a major part of KiwiSaver II is already law (the so-called "tax credits" on members' contributions), with no debate. We hope, however, to place some sort of peg in the ground to support the principle of consultative policy-making and considered debate before major changes are made.

This submission on the Bill looks just at KiwiSaver II and is in the following sections:

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[1] RPRC's submission is made by **Susan St John** BSc, MA, PhD - Senior Lecturer Economics, Department of Economics, University of Auckland; Consultant OECD, private pensions 1990; Deputy Chair, Periodic Report Group 1997 and **Michael Littlewood** BA/LLB, Director Aventine Consulting Limited, Auckland; Member, Prime Minister's Working Group on Superannuation 1990; Member, Task Force on Private Provision For Retirement 1991-92.

Section 2: looks at New Zealand evidence that suggests KiwiSaver II is a solution looking for a problem.

Section 3: reviews overseas evidence showing that neither tax incentives for retirement saving nor compulsion appear to work, if raising national saving levels is the aim.

Section 4: looks at why KiwiSaver II is a potential threat to the long-term future of New Zealand Superannuation.

Section 5: questions the process of change and the political motivation.

Section 6: questions why the government has not justified KiwiSaver II by a Regulatory Impact Statement.

Section 7: tests KiwiSaver II against the OECD's measures of high quality regulation and suggests that it fails those measures.

Section 8: suggests that the so-called "compulsory employer contributions" will be an illusory gain for most employees.

Section 9: shifts the focus of our submission to the now complex choices faced by an employee in structuring remuneration to minimise tax and maximise state entitlements

Section 10: summarises the case that the political clock has been set back 30 years on superannuation.

We call for evidence to support the radical re-write of KiwiSaver I and we ask that KiwiSaver II be submitted to a proper, evidence-based review process.

As a research-based organisation, we offer both local and international evidence in support of our comments. Anyone who wishes to review that evidence will find all the papers referred to on our web site:

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KiwiSaver I was a relatively modest intrusion into the private saving decisions of New Zealanders and the remuneration arrangements of New Zealand employers and had some positive features. Despite some criticisms, it provided a portable, essentially voluntary means for workers to enter work-based saving schemes. Good saving habits can be encouraged by regular pay deductions.

KiwiSaver II fails the test of reasonableness. It is not really about saving for retirement as much as giving tax reductions in a complex, regressive, expensive way and for political advantage.

KiwiSaver II could prove to be a step backwards into a re-run of a regrettable period of our superannuation history.

Section 2 – New Zealand evidence

In which we look briefly at New Zealand evidence supporting our contention that KiwiSaver II is a solution looking for a problem to solve.

What follows is only a brief summary of the key findings from a number of research papers that have been reviewed on www.PensionReforms.com:

2.1 How are New Zealand's old faring now?

- This is ground-breaking work by the Ministry of Social Development – developing an "Economic Living Standards Index" (ELSI);
- The old (65+) have the smallest levels of "hardship" – only 8% have any at all;
- "Hardship" seems unrelated to "financial" assets – 59% have $25,000 or less;
- Owning a debt-free home is important.

So, there seem to be no real problems for those who have already retired.

New Zealand Living Standards 2004
Ministry of Social Development (2006)

2.2 Are New Zealanders saving enough for retirement?

- Reviews the micro-economic evidence;
- Develops a model of retirement wealth accumulation;
- Uncovers tentative evidence that there seems to be no wide-spread undersaving for retirement;
- Many should not be saving anything (or anything more) as New Zealand Superannuation provides sufficient consumption-smoothing.

Saving for Retirement: New Evidence for New Zealand
Grant Scobie and Le Thi Van Trinh (2004)

2.3 Can we learn anything useful from macro-economic evidence?

- Reviews different sources of New Zealand information on saving issues;
- The normal "macro-economic" evidence (household saving) needs adjustments before it can be used to inform the retirement income debate;
- There is inadequate information available to draw lasting conclusions on the major policy issues.

Saving in New Zealand: measurement and trends
Iris Claus and Grant Scobie (2002)

2.4 New Zealanders seem to be saving enough for retirement

- First evidence available from the Survey of Family Income and Expenditure (SoFIE);
- "Little or no insight into retirement savings can be gleaned from aggregate measures of household saving rates";
- Only the assets, liabilities and behaviour of households (micro-economic data) can tell us what we need to know about retirement savings;
- About two-thirds of New Zealanders aged 45-64 seem to be saving enough (or more than enough) to ensure a continuation of pre-retirement consumption at 100% on into retirement and, in the case of couples, until the second death;
- This measure of saving "adequacy" is based on a number of conservative assumptions, including that the home is passed on to the next generation as an inheritance (and not "eaten" as part of retirement consumption).

Are Kiwis saving enough for retirement? Preliminary evidence from SoFIE
Trinh Le, Grant Scobie and John Gibson.

2.6 Conclusion – the New Zealand evidence

The best evidence we have is that New Zealanders seem generally to be saving enough for retirement. This comes from the Government's own advisers and is not undermined by the Treasury's report on the eve of the 2007 Budget and that seemingly supported its Minister's decision on the tax-subsidisation of savings[2]. We suggest that the report's justification (a "least regrets" approach) for the spending of more than $1.2 billion a year on KiwiSaver is unconvincing.

Even if some New Zealand households are undersaving for retirement we question that KiwiSaver II is the best way to correct this.

Other ground-breaking government evidence (paragraph 2.1 above) shows that the currently retired, as a group, have the lowest levels of hardship of any group in the community.

Looking to the future, it is likely KiwiSaver will result in greater disparities among low income retired people. If there is a gap, it might be in the lack of opportunity for middle-income people to annuitise and so secure a,reliable income replacement rate in retirement. This gap is not addressed by KiwiSaver II.

[2] *A Synopsis of Theory, Evidence and Recent Treasury Analysis on Saving,* The Treasury (2007)

Section 3 – overseas evidence

In which we briefly review overseas evidence that seems to show that neither tax incentives for retirement saving nor compulsion seem to work, if raising national saving levels is the aim.

What follows is only a brief summary of the key findings from a number of international research papers that have been reviewed on www.PensionReforms.com.

3.1 An international view – what drives 'saving'?

- Higher output growth boosts saving;
- "Fiscal consolidation" is linked to increased saving;
- Private credit increases tend to reduce saving;
- Ageing populations reduce saving;
- Better 'terms of trade' tend to increase saving;
- Saving behaviour may not be affected by returns;
- Increased credit may mean firms invest more;
- A higher cost of capital seems associated with lower investment.

Generally, to the extent that there was any connection between saving and growth, the paper seemed to suggest that saving was caused by growth, rather than the other way round.

KiwiSaver II seems founded on the principle that growth is caused by saving.

World Economic Outlook, 2005
IMF

3.2 Can governments change things? 1

- International evidence seems to be that 'no, they cannot';
- For example – this is a 48 country study covering the period 1980 to 2004;
- $1 in pension saving adds 0-20 cents in national saving;
- Ignores cost of incentives, regulation and sub-optimal investment decisions;
- Small "improvement" with maturity;
- "Reforming countries" don't seem to be different.

Generally, even countries that have made saving compulsory (the "reforming countries" in the paper, seemed to have only modest impacts on national saving. Citizens seemingly adjusted their other behaviour to compensate.

Pensions and Saving: New International Panel Data Evidence
Bebczuk and Musalem (2006)

3.2 Can governments change things? 2

- This report offers more evidence that the answer seems to be 'no';
- Seven country study – 1970 to 2000;
- Voluntary pension savings are largely not 'new' money;
- "We found substantial evidence that pension saving substitutes for other forms of private saving."

Pension Reform and Saving
Bosworth and Burtless (2004)

3.4 Do tax incentives work - 1?

Tax incentives for retirement savings seemingly reward savers for "appropriate" behaviour:

- Incentives certainly change behaviour;
- Direct incentives probably don't increase saving;
- ".. between 0 and 30 percent of 401(k) balances represent net additions to private saving."
- Ignores direct and indirect costs of incentives.

The Effects Of 401(k) Plans On Household Wealth
Engen and Gale (2000)

3.5 Do tax incentives work – 2?

In 1988 Spain introduced generous incentives for retirement saving where none had existed before. This report reviews contemporary evidence from household consumption data and concludes:

- Something less than 25% of contributions to the, now, EEt retirement income schemes represented reduced current consumption;
- The greatest contributions came from the 55 to 64 year age group (as expected) but that group showed the least reduction in consumption (arguably none) so the savings represented financial re-arrangements rather than new savings;
- The analysis ignored the costs to taxpayers of the incentives themselves and also the regulatory costs involved in their supervision. If those were allowed for the results on households could easily have been negative.

The Effects if the Introduction of Tax Incentives on Retirement Savings
Ayuso, Jimeno and Villanueva

3.6 Does compulsion work?

This report was a 13 country review of Latin America that illustrated 11 lessons, including:

- A growing 'informality' of labour force (more people ceasing to be "employees" to avoid compulsion);
- 'Ownership' of the retirement saving issue by savers doesn't solve evasion;
- Suppliers tend to concentrate to a few (in environments where savers have the right to move);
- Competition doesn't work to control costs;
- The market doesn't solve mortality risk issues;
- The effect on national saving is uncertain;
- There are large, regressive, long-tail fiscal costs in the transition from a PAYGO state pension to a pre-funded "private" pre-funded alternative;
- Compulsion may have made markets more liquid (but may not);
- Investment risk adds to social risks[3].

Reassessing Pension Reform in Chile and Other Countries in Latin America
Mesa-Lago (2002)

3.7 Higher 'savings' = growth?

The transition from KiwiSaver I to KiwiSaver II seems to be based on the propositions both that governments can change savings behaviour in ways that it deems appropriate but also that more saving for retirement matters to a country like New Zealand. This report that questions that second apparent objective:

- More savings seem to matter for 'poor' but not so for 'rich' countries;
- This was a review of 118 countries over the 40 years 1960-2000;
- Open capital markets disrupt theories based on closed economies;
- Local saving matters for innovation in 'poor' countries – this seems not to be significant for 'rich' countries.

When Does Domestic Saving Matter for Economic Growth?
Aghion, Comin & Howitt (2006)

3.8 Some research from Australia

There is much anxiety expressed in New Zealand's business press about the apparent "success" of the Australian compulsory regime. Given that most New Zealand financial service organisations are Australian-owned, we must not be surprised that they echo (or perhaps even promote) those concerns.

[3] Argentina recently announced that members of its compulsory scheme would have the right, each five years, to "buy back" into the unfunded, PAYGO state pension.

What follows looks very briefly at some relevant findings from the various research papers reported on www.PensionReforms.com:

- Australia has, despite compulsion, run significant, persistent current account deficits – 4.5% p.a. for 20 years (Treasury 2005);
- Australia's aggregate saving rate is not markedly different to New Zealand's (OECD) despite compulsion;
- There is some evidence of compulsion's influence on household saving rate (Reserve Bank of Australia reports – 2000, 2004) but it took 13 years of full compulsion (and 18 years of a lesser variety) before there those signs;
- Superannuation assets constitute only 6% of Australian median household wealth (HILDA 2001-02) – HILDA was the first look at the assets and liabilities of Australian households in 95 years, a real surprise given governments' interventions in the saving decisions of Australians;
- In the six years to 2000, superannuation assets increased by about the same as household debt (Treasury 2003);

As far as we have been able to discover, there has been no research done on the preparedness of Australians for retirement (as per the Scobie et al. analyses for New Zealand that we have summarised in Section 2). Given the huge amounts spent by Australians on superannuation both directly and through tax breaks[4], this gap is at least surprising.

3.9 Conclusion – the international evidence

The overseas evidence is clear – governments' policies on saving can re-arrange families' balance sheets but do not have much effect on overall saving behaviour. That evidence comes from long-term, multi-national studies that include countries with compulsory saving schemes.

This evidence seems easily explained – individuals simply adapt their behaviour to take account of their government's policies. We can expect that New Zealand's experience will be similar to those of other countries.

[4] According to a recent press report, the cost of tax incentives for retirement in Australia now exceeds 2% of GDP (83% of the whole cost of the Age Pension in Australia.

Section 4 KiwiSaver II- a potential threat to New Zealand Superannuation?

In which we say why we think KiwiSaver II is a potential threat to the long-term future of New Zealand Superannuation.

4.1 The economics of ageing

The underlying premise of KiwiSaver II seems to ignore the economics of an ageing population. KiwiSaver II might be a long-term threat to New Zealand Superannuation, because an unfunded state pension and a pre-funded, private arrangement both operate in similar ways when it comes to draw down the benefits.

The material living standards of people in retirement are largely determined by their ability to consume goods and services. Retirees cannot consume the money represented by public or private savings directly. Those savings must be used to buy goods and services that are produced at the time by New Zealand's working-age population or by workers of other countries (imports). The British economist, Nicholas Barr, memorably expressed this point in these terms:

> "Pensioners *do not* eat pound note 'butties' – they use the pound notes to purchase consumption, and it is consumption that matters."[5]

It is New Zealand's capacity to create wealth that matters. The ability to produce goods and services and to buy imports are the keys to the living standards of present and future retirees. That doesn't mean that we shouldn't save for retirement; only that savings by themselves won't help. It's what is done with those savings (investment and then growth) that matters.

The increased amounts of money in superannuation as a result of KiwiSaver II will probably not help increase the capacity of tomorrow's New Zealand workers to produce more for tomorrow's retirees to consume.

4.2 Why the worry about New Zealand Superannuation – a case in point?

In the context of KiwiSaver II, there has been no real discussion on the future of New Zealand Superannuation. The government says that New Zealand Superannuation will be unaffected – that KiwiSaver benefits will be in addition to the state pension. We question that assertion.

Let us illustrate the point with a sample calculation for a 25 year old who earns the national average wage of $43,873 a year for the whole of his working life. This is the wage used in the New Zealand Superannuation calculation. The employee's 4% contribution is matched by the employer after four years – net real returns of 2.5% a year and pay rises of 1% a year above inflation complete the sample case.

On these guesses, our KiwiSaver ends with $320,300 in today's money – that's the equivalent (for a single male at age 65) of an inflation-proofed annuity of

[5] Barr, N A (1979), "Myths My Grandpa Taught Me", *Three Banks Review*, No 124, pp 27-55 at p 35.

about $22,000 a year after tax. Of that, about 33% has come directly from taxpayer-funded subsidies.

New Zealand Superannuation for a single person is currently $14,407 (after tax) so, in today's money, our KiwiSaver's total retirement income will be $36,407 a year from age 65. That's 105% of today's after-tax pay[6].

We offer two observations on this example:

- As a first point, how does this expectation of our sample KiwiSaver member square with the government's original objective of reducing the future cost of retirement incomes to taxpayers? Higher retirement incomes must mean higher costs for tomorrow's economy. The implication that tomorrow's retirees will somehow be paying for their own retirement incomes and letting tomorrow's taxpayers off the hook is an economic illusion.

- Anyway, tomorrow's government could say, reasonably, that we have already helped our saver to pay for that KiwiSaver annuity. We are therefore entitled to recognise that help in the retirement income we pay through New Zealand Superannuation. That's what happens now in Australia.

4.3 The potential threat

We have set off down the Australian compulsory saving path so an income and asset-tested New Zealand Superannuation pension seems a logical conclusion. The government naturally shies away from any such suggestion. It even criticises the opposition for observing some of the economic fundamentals that we have described in this section.

The government may wish to deflect any similar thoughts beyond the next election in 2008. That is, however, no way to run a debate on the long-run future of retirement income provision in New Zealand. We need to start talking now about what KiwiSaver II means for the long-term future of New Zealand Superannuation.

[6] We have expressed the benefit in this way to avoid having to make assumptions about likely tax rates. With growth in real pay, the proportion will be smaller but still very significant (if tax rates are linked in some way to inflation).

Section 5 An extraordinary process of change

In which we question the process of change and its political motivation.

5.1 KiwiSaver I process

The development of KiwiSaver I started with an objective – the Savings Product Working Group (SPWG) was set up by the government to:

> "…to provide advice to the Government on the detailed design and implementation issues to be resolved in delivering widely adopted generic work-based savings products."[7]

It should be noted that there was no question that such products were needed; no question either as to whether such products were not already available (they were). There was an assumption as to the outcome.

The SPWG consulted with interested parties but it was clear that the outcome was pre-determined. There was a job to be done.

The SPWG reported in September 2004 and recommended a "pathway" of escalating interventions. The final step was what would become KiwiSaver I. Whatever the SPWG's intentions, the government's motives were clear. It first sought submissions on the SPWG's report but didn't acknowledge them or engage in any debate on the issues raised.

We next heard about the issue in the 2005 Budget when KiwiSaver I was announced in a fully completed form. There was to be debate only on the detail. Nothing of the substance was discussed.

The KiwiSaver Bill then emerged – submissions and hearings for those took place in the middle months of 2006. Again, changes were recommended by the Select Committee only as to the detail. None of the substantive questions as to the need for KiwiSaver was addressed.

However, when the Bill moved through its final stages, two significant changes were added:

- **Contributions by an employer** were to become exempt from tax (SSCWT). This was a total surprise as there had been no suggestion of it through the whole process to date. There was no debate or research-based justification – it just happened.

- **The mortgage diversion scheme**, rejected by the Select Committee, was restored. This was a cosmetic add-on that had no economic or financial advantage for KiwiSaver I members. In fact, along with the first home subsidy scheme, it seemed to conflict with the government's objectives to reduce New Zealanders' investment in housing.

[7] Terms of Reference – Savings Product Working Group

The defects in the KiwiSaver I process were immediately apparent as existing superannuation schemes protested the granting of tax favours to KiwiSaver schemes. The government then announced that some types of private (non-KiwiSaver schemes) would also qualify for the concession – the so-called "complying funds".

And so, after an 18 month gestation period, we all thought we understood what would be starting some nine months later – on 1 July 2007.

5.2 The Budget announcements

Just six weeks before KiwiSaver was to begin; just as the finishing touches were being applied to legal requirements and member communication; as administration systems were coming to the end of their development, the whole financial services industry was turned upside down.

Without debate; with not even any discussion as to the implications on everything that was then happening, the government re-wrote the KiwiSaver rules. Now we were to have:

- tax subsidies for members;
- tax subsidies for employers (over and above the tax exemption on employer contributions that appeared at the last minute with KiwiSaver I);
- compulsory employer contributions.

There was to be no consultation over any of this – the tax subsidies for member contributions were to take immediate effect.

And all this just six weeks before KiwiSaver I was to begin[8].

5.3 No way to run a retirement saving scheme

We suggest that the government has probably undermined the confidence of the financial services industry in the process of change. Large amounts of work had been wasted.

There are many signs in the design of, now KiwiSaver II of inexperience and a lack of recognition of the complexities of superannuation scheme administration. The government has significantly lifted the risk of administrative failure and that will also be a potential threat to the public's confidence in KiwiSaver.

We are already seeing speculation as to what changes might follow a change of government and that does nothing for individuals who are making decisions that have to last for decades.

[8] By contrast, the United Kingdom started discussions more than two years ago on a similar (but simpler) national, auto-enrolment scheme that is expected to start in 2011 (after six years),

Whatever happens to KiwiSaver as a result of this upheaval, we must discuss ways to avoid this kind of overnight change to either public or private superannuation provision.

Section 6 Why no Regulatory Impact Statement?

In which we wonder why the government has not justified KiwiSaver II by a Regulatory Impact Statement.

6.1 A contrast

We were struck by the fact that there is no Regulatory Impact Statement (RIS) in the Bill with respect to the KiwiSaver II changes – the presence in the Bill of five other RISs made more stark the absence of one for KiwiSaver II. We thought it might be helpful to suggest some of the questions that the missing RIS might have asked under the same headings used for the other RISs.

6.2 Statement of the public policy objective

What are the public policy objectives for a more than doubling of the estimated cost of KiwiSaver to taxpayers?

We have already suggested that most New Zealanders seem to be making adequate provision for their retirement (see Section 2). There seems to be no justification for KiwiSaver II in the micro-economic evidence that we have summarised in Section 2 of this submission. Nor is it clear that the national savings problem is addressed by KiwiSaver II.

6.3 Statement of the nature and magnitude of the problem and the need for government action

What exactly is the "nature and magnitude of the problem" that the Bill is intended to address? We have seen statements by the government that it wanted the changes to be a surprise and to jolt New Zealanders' focus towards KiwiSaver.

This was six weeks before KiwiSaver I started; before any advertising started; before most New Zealanders even knew what KiwiSaver was. It is very difficult to see KiwiSaver II as a justification for this apparent lack of awareness.

Why therefore is there the need for government action to produce KiwiSaver II?

6.4 Statement of feasible options (regulatory and/or non-regulatory) that may constitute viable means for achieving the desired objective

Given that there is no clear statement of the government's objectives or the need for action, it is not possible to suggest "feasible options …that might constitute viable means for achieving the desired objective."

6.5 Statement of the net benefit of the proposal, including the total regulatory costs (administrative, compliance, and economic costs) and benefits (including non-quantifiable benefits) of the proposal, and other feasible options

The "administrative, compliance and economic costs" of KiwiSaver II will be significant. Given the economic risks that we have identified, it is difficult to see what KiwiSaver II's "net benefit" might be. As far as we know, no "other feasible options" have been examined.

6.6 Statement of consultation undertaken

No consultation has been undertaken on KiwiSaver II.

6.7 Compliance costs

We have been given estimates of the likely cost of KiwiSaver II but no estimates of the likely costs of compliance. These are likely to be very significant for taxpayers, providers and therefore, ultimately, for members. Providers will eventually pass on all the increased costs involved in fees.

Section 7 KiwiSaver II fails the OECD's tests of quality regulation

There has been much public discussion about whether New Zealand has a savings problem and what initiatives the government might consider to correct a perceived difficulty with the behaviour of New Zealanders. We examine this issue in the context of the *OECD Guiding Principles for Regulatory Quality and Performance.*

7.1 Principle 1: serve clearly identified policy goals and be effective in achieving those goals.

The Bill's stated goals are expressed in the Bill's *Explanatory Note* as follows:

> "Encouraging saving contributes, in particular, to the Government's Economic Transformation and Families—Young and Old themes, with the following broad objectives:
>
> *A better retirement*
>
> - ensuring all New Zealanders have the opportunity to save to secure a better standard of living in retirement.
>
> *A stronger economy*
>
> - helping to reduce pressure on inflation and the current account deficit;
> - furthering development of stronger and deeper capital markets; and
> - offering a more competitive package of workplace rewards.
>
> *A fairer society*
>
> - providing a greater and broader ownership stake in New Zealand; and
> - reducing large inequalities in wealth, which tend to undermine social cohesion."[9].

We deal in paragraph 7.2 with the evidence cited in support of these goals.

We think that the Bill's goals are clearly stated and we support them as far as they go. However, we wonder what "offering a more competitive package of workplace rewards" could mean in the context of a retirement savings scheme that must be offered to everyone by all employers. How does that make workplace rewards "more competitive"? Perhaps this refers to the "compulsory" employer contributions. We have more to say about this in the next Section 8.

For reasons that we describe shortly, we think there is a significant risk of the Bill's failing to achieve those goals. We suggest the Bill has only partly achieved Principle 1.

7.2 Principle 2: have a sound legal and empirical basis

No evidence is provided in support of the goals identified in paragraph 7.1. There is no Regulatory Impact Statement and not even an attempt to justify how the Bill might achieve the stated goals.

[9] The Bill, page 2.

The Bill assumes that KiwiSaver will achieve the goals summarised in paragraph A.2 above but offers no evidence that each of these apparent deficiencies will be addressed. In fact, we think there is a risk that KiwiSaver may lead to:

(i) Reduced employer-subsidised superannuation provision including the winding up of current schemes;

(ii) A large increase in superannuation membership but only to collect the government's tax breaks. The New Zealand evidence (Section 2) indicates that New Zealand does not have a retirement saving problem; the international evidence (Section 3) indicates that, even if we did have a retirement savings problem, tax breaks and "soft" compulsion are unlikely to fix it.

(iii) Reduced provider choice as smaller providers that fail to obtain scale withdraw from the market.

(iv) Barriers to entry for new providers that will face difficulties in obtaining traction and scale in the face of large, favoured, incumbent "default" providers.

(v) Higher costs for other superannuation-related services (voluntary member savings, employer subsidies, insurance and advisory services) as providers seek to recover costs from loss-making KiwiSaver accounts, especially during the start-up phase.

In the absence of any evidence to support the Bill's objectives, we suggest that the Bill falls short of meeting the requirements of Principle 2.

7.3 Principle 3: produce benefits that justify costs

The OECD suggests that governments consider the distribution of effects across society, taking economic, environmental and social effects into account. Unfortunately, the Bill offers no evidence of the likely effect of KiwiSaver II on retirement saving behaviour across different age groups, ethnic groups, income levels, different types of employee (part-time, fulltime; broken careers etc).

The only evidence we have on these different groups (Section 2) indicates that these groups are, in general, coping reasonably well on their own with their retirement saving projects.

There are no estimates of benefits from what the government says will be a doubling of expenditure on KiwiSaver other than the generic statements quoted in paragraph 7.1 above.

We therefore suggest that the Bill fails Principle 3.

7.4 Principle 4: minimise costs and market distortions

Given the scale of KiwiSaver II's intervention, we think that, by using the current superannuation environment coupled with the collection and remission

function assumed by the IRD, the Bill does help to limit disruption, and therefore compliance costs.

However, we suggest that KiwiSaver II has conferred further, significant property rights on the default providers that will create unnecessary market distortions.

We therefore suggest that the first leg of Principle 4 is partly achieved but the second leg is failed.

7.5 Principle 5: promote innovation through market incentives and goal-based approaches

KiwiSaver schemes are prescriptive. In part, that was justified with KiwiSaver I to ensure simplicity but it is mainly because KiwiSaver is about just one form of saving (first home deposit scheme aside).

KiwiSaver II itself will constrain, rather than promote innovation – apart from investment performance differences, there is unlikely to be anything to choose between alternative providers, particularly the limited number of default providers. For the reasons already described in paragraph 7.2, we also think that some of KiwiSaver's goals will be compromised by its deliberately inflexible nature.

We think that the Bill fails Principle 5.

7.6 Principle 6: be clear, simple and practical for users

We think that KiwiSaver II's existence has not been justified.

For the reasons discussed in Section 9, remuneration arrangements to minimise tax and minimise flexibility have now become complex and will touch employees at all tax levels.

We think that the Bill falls short with respect to Principle 6.

7.7 Principle 7: be consistent as far as possible with other regulations and policies

For the last 16 years (since the tax changes of 1987-1990), the government has maintained a relatively level savings playing field for income tax. Unlike all other developed countries, New Zealand has offered no tax incentives for retirement saving[10]. The reasons for New Zealand's policy are clear but are still not generally accepted in New Zealand. Tax incentives are very expensive, favour the rich (largely at the expense of those who can't afford to save) and there is no proof internationally that they increase saving. They do shift savings around – tax-favoured schemes attract large sums from those who *can* afford to save. However, they are expensive to administer and greatly distort saving and investment behaviour. Neither do they seem to actually enhance saving much.

[10] We acknowledge the minor incentives allowed for "salary sacrifice " arrangements but a very small number of employees have made use of this small tax break for saving.

These principles have been completely overturned by KiwiSaver II.

We think this is a break from the policies of the past and we suggest that the change has not been justified while the risks of the money spent each year being wasted (by failing to secure the required behavioural change) are likely to be significant.

With respect to superannuation, we think that KiwiSaver II breaches a fundamental principle of other government policy on giving "rewards" for particular behaviours that are centrally designated. It therefore fails Principle 7 of the OECD's *Guiding Principles*.

There is another indirect risk from the breach of Principle 7. We think there is a significant risk that KiwiSaver will fail to reach its objectives. That will lead to calls from providers and then by politicians to "switch off" the opt-out facility. That will be a small legislative and administrative change, given that the framework will already be in place. However, it will have large policy repercussions. If change happens in the same manner as KiwiSaver itself was introduced, that risk will be significantly increased. On this ground alone, we can argue a breach of Principle 7.

7.8 Principle 8: be compatible as far as possible with competition, trade and investment-facilitating principles at domestic and international levels

While any financial service provider can start a KiwiSaver, the commercial reality is that "default" providers will be the main commercial winners in the KiwiSaver environment. That will confer a commercial advantage on those providers with other aspects of their superannuation and advisory businesses.

We see no reason to confer that advantage on a favoured group. Widening the group of those providers would be "compatible …. with competition and investment facilitating principles".

We think that the Bill fails Principle 8.

7.9 Summary – the Bill's scorecard

Here, in summary, is our assessment of the Bill against the OECD's eight measures:

No.	Principle	Assessment
1.	Clear objectives	Partial pass
2.	Sound legal & empirical basis	Failed
3.	Benefits that justify costs	Failed
4.	Minimise costs and distortions	Partial pass
5.	Promoting innovation	Failed
6.	Clear simple and practical	Failed
7.	Consistent with other policies	Failed
8.	Compatible with competition, trade etc	Failed

Section 8 Illusory compulsory employer contributions

We suggest that the so-called "compulsory employer contributions" will be an illusory gain for most employees.

8.1 A major intervention in the employment contract

Some will think that at last, we will have all employers subsidising the retirement savings of ordinary Kiwis – somehow everyone's total remuneration will be increased by the employers' contributions. Not so.

Employers will certainly be obliged to put money into KiwiSaver but that will still be part of their employees' pay – it's just that the government is saying that employees can't get it now – they have to wait until age 65.

8.2 Implications without change

Here is the implication if the employer simply allowed KiwiSaver to happen:

- Employees who can afford to join or who think it's important to save for retirement will become KiwiSaver members;
- Other employees won't join.

Those who join will receive a higher total remuneration than those who don't, because:

- **Kick-Start.** The government will pay a lump sum of $1,000 to the employee's account after three months' membership.
- **Tax subsidy.** Each year, the government will pay up to $1,042.86 a year tax-free as a match to the employee's contributions (the "tax credit").
- **Employer contributions.** By 2011, the employer is obliged to match the employee's contribution of 4% of pay. That is also tax-free.

Employees who join KiwiSaver will have 7 - 9% more total remuneration than those who do not.

We shall put aside whether the employer can afford the compulsory contributions or even whether the employer thinks subsidised superannuation is a good idea. Instead, we think the employer should want to feel comfortable about the idea that those who can afford to save should be paid more in total for doing the same job as those who cannot afford to join.

8.3 An alternative strategy - "total remuneration" post KiwiSaver II

Employers can allow KiwiSaver just to happen - as employees begin to understand what's at stake, the employer's payroll costs will increase as employees join. Whereas a "compliance only" option may have been justified

under KiwiSaver I, we expect that employers will now take the initiative. "Compliance only" is no longer an optimal response.

To keep the example case simple, let's assume we are at 2011 so that the employer is obliged to contribute 4% of the pay of any employee who joins KiwiSaver. Let's also assume the employer is faced with increasing pay to allow for inflation and growth. The proposed increase for all staff just happens to be 4% as well. Here's what the employer could say to employees:

> "This year, we are proposing to increase your overall remuneration by 4%. You have choices about how to receive that. You can:
>
> - take the increase as taxable pay;
> - "salary sacrifice" the 4% as an employer's contribution to a normal, accessible superannuation scheme - withholding tax will apply to this contribution;
> - join KiwiSaver - in this case, you must pay 4% from your after-tax pay and the employer's contribution to KiwiSaver will be tax-free.
>
> From now on, this part of your pay (4%) will be called the "Superannuation Component" and you can change what you want to do with it on one month's notice."

Put this way, the employee will choose what suits the employee's personal circumstances. The employee can make the trade-off between net cash today, net contributions that will be available on leaving service or the highest net contribution, locked up in KiwiSaver until age 65.

8.4 Implications of post-KiwiSaver "total remuneration"

From the employer's perspective, adopting the "Superannuation Component" approach means that all employees will be treated on a common basis. Remuneration patterns are protected and the employer allows employees maximum flexibility.

The employer will also gain the tax credit with respect to any employer's contributions paid to KiwiSaver. So it will be in the employer's financial interest that employees join KiwiSaver. The employees themselves cost no more but the Inland Revenue will pay up to $1,040 a year to the employer for each member.

During each of the four transition years, (2008 - 2011), the same principles will apply. As each year passes, the employee will decide whether to remain as a KiwiSaver member and so gain the advantage of the tax-free status of the employer's contributions (and the other government subsidies).

If an employee decides, initially, not to join KiwiSaver but to take the "Superannuation Component" as taxable pay, the employer should maintain the formal separation of the "Superannuation Component" from the rest of the employee's pay and communicate that on a regular basis. That's because the employee can, at any time, choose to join and so trigger the employer's KiwiSaver obligation. If that happened, the employee's taxable (and take-home) pay will reduce to compensate.

If the employer hadn't intended to increase pay by 4% next year, it may have to take 2 - 3 years to reach the full "Superannuation Component" of 4%. In each

year, the employer will identify what, if any of an increase, forms part of the Superannuation Component until it reaches 4%. After that, it will need to top up the "Superannuation Component" to maintain the full 4%.

8.5 "Superannuation Component" – a caveat

Employers do not operate in a vacuum – the government might legislate to limit an employer's flexibility to set pay and benefits. Unions may think that employers are trying to thwart the government's objectives. Employees may think they are being treated unfairly by comparison with employers that operate on a "pay + benefits" basis.

None of these is true but each underlines a requirement for good communication on the way in which the employer reacts to the government's KiwiSaver requirements over the next four years.

In conclusion, the "compulsory" employer contribution need not represent an impost provided the process is managed. It will however be confusing, especially for small employers with less sophisticated remuneration practices.

8.6 Unintended consequence – reduced "national average wage"

If all employees' cash incomes reduce in real terms to reflect KiwiSaver's compulsory, deferred income, the national average wage (the measured cash in the hand) will be permanently lower than otherwise with respect to all employees who join KiwiSaver II. That will mean a reduction in New Zealand Superannuation in real terms because it is based on the average wage. That reduction will affect all superannuitants, including the currently retired. Indirectly, they will be helping to pay for KiwiSaver II's tax breaks by reducing the future cost of New Zealand Superannuation.

Section 9 Re-arranging remuneration – now a complex set of options

We shift the focus of our submission to the now complex choices faced by an employee in structuring remuneration.

9.1 Major changes to the tax playing field

The last few years have seen major changes to the definition of "income" for tax purposes. In summary, those changes can be summarised under the following main headings:

- **"Salary sacrifice"** allows an employee to manipulate the definition of what is taxed as income, what is subject to superannuation's SSCWT and what counts as "income" for various income-tested, state-provided entitlements.
- **SSCWT** now needs to have only a passing relationship with an employee's personal tax liability;
- **KiwiSaver** is now ETE with respect to employer's contributions and tTE with respect to the employee's contributions (because the so-called "tax credit" provides a diminishing tax advantage as pay increases).
- **Income-tested** benefits apply to many more employees than used to be the case.
- **PIEs** will increase the ability to manipulate tax with a careful mix of taxable income and PIE income for the relatively favoured few.

9.2 Potential to manipulate net income

With the introduction of each change, the government has moved steadily away from "natural" definitions of income and therefore the tax that should be paid.

However, the new tax planning landscape is now complex. We have produced a Briefing Paper to illustrate the potential that now exists[11]. In the example shown in the Briefing Paper, an employee who started with "total remuneration" of $100,000 gained a direct saving of $4,749 over the directly taxable $100,000. There was also the potential to gain a further $2,970 a year in savings because of the operation of the new PIE regime.

We think that this trend to greater complexity and the increased ability to manipulate "income" and therefore tax are both retrograde steps.

We regret these developments.

[11] That Briefing Paper is available on the RPRC's web site at www.rprc.auckland.ac.nz

Section 10 KiwiSaver II – a retrograde political step

In which we regret that the government seems to have turned the political clock back 30 years on superannuation.

10.1 The settled decades

For 20 years, we had a relatively settled environment for private retirement saving. The 1987-1990 tax changes made life relatively simple for savers. Only an accidental "salary sacrifice" opportunity aimed at higher earners in 2000 muddied these waters.

New Zealand Superannuation has been settled since the 1993 Accord and still retains broad political consensus.

10.2 The upheaval begins

Private provision is no longer settled. From the "Savings Product Working Group" in 2004 through KiwiSaver I and now KiwiSaver II, private provision for retirement is in upheaval. The new PIE regime tax changes that start on 1 October 2007 are the next set of changes. The debate about the introduction of compulsory employer contributions will probably be the next chapter in the KiwiSaver saga.

Whether we agree on the need for KiwiSaver I, let alone KiwiSaver II, the process we are enduring raises serious issues. History seems to be repeating itself.

We should remind ourselves of the to-ing and fro-ing that started with the Douglas compulsory superannuation scheme in 1974. Then, in relatively short order we got "National Superannuation", the "surcharge", the tax changes, "Guaranteed Retirement Income" and what seemed to be the final straw, the 1991 Budget's "clawback".

10.3 Stability begins

By the time the Task Force on Private Provision for Retirement started work in 1991, the electorate's anger was at white heat.

The Task Force first faced the combatants and gathered information about what mattered and what did not. By the final report in December 1992[12], the options and the main issues had been identified. The optimal way forward was relatively obvious and led to the 1993 Multi-Party Accord. That took both public and private provision for retirement off the political agenda because the issues had been thoroughly canvassed.

[12] *Private Provision For retirement: The Way Forward* (1992)

10.4 A flawed process

The process we have described with respect to KiwiSaver is seriously flawed. That is best illustrated by National's silence on KiwiSaver II. The government probably thinks that, by the next election, it will have boxed National into a corner on KiwiSaver II. But National has a number of options and is probably content not to be drawn into a debate before the election year.

Next year, we can expect to see National suggesting changes to KiwiSaver II. And then we may see a repeat of the seesaw process that New Zealand endured between 1974 and 1993.

On a very long-term project like private retirement saving, we strongly suggest that it is not good enough.